APPENDIX G (Part 1)

APPENDIX G

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

X ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2003 or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ___________ to ___________

Commission File Number 000-26489

ENCORE CAPITAL GROUP, INC.
(Exact name of registrant as specified in its charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	**48-1090909** (I.R.S. Employer Identification No.)
5775 Roscoe Court, San Diego, CA (Address of Principal Executive Offices)	**92123** (Zip Code)

(877) 445-4581
(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act: None
Securities registered pursuant to Section 12(g) of the Act:

Common Stock, $.01 Par Value Per Share
(Title of Class)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes [ ] No [X]

The aggregate market value of the voting stock held by non-affiliates of the registrant totaling 2,136,735 shares was $18,803,268 at June 30, 2003 based on the closing price of the Common Stock of $8.80 per share on such date, as reported by the Nasdaq National Market.

The number of shares of the registrant's Common Stock outstanding at February 10, 2004 was 22,020,016

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PART I

Item 1 — Business

An Overview of Our Business

Nature of Business
Encore Capital Group, Inc ("Encore") is a systems-driven purchaser and manager of charged-off consumer receivables portfolios. Encore acquires these portfolios at deep discounts from their face values using its proprietary valuation process that is based on the consumer attributes of the underlying accounts. Based upon the ongoing analysis of these accounts, Encore employs a dynamic mix of collection strategies to maximize its return on investment. Encore is a Delaware holding company whose principal assets are its investments in its wholly-owned subsidiaries, Midland Credit Management, Inc. ("Midland Credit"), Midland Funding 98-A Corporation ("98-A"), Midland Receivables 99-1 Corporation ("99-1"), Midland Acquisition Corporation, MRC Receivables Corporation ("MRC"), Midland Funding NCC-1 Corporation ("NCC-1"), and Midland Funding NCC-2 Corporation ("NCC-2") (collectively referred to herein as the "Company," "we," "us," or "our"). Encore also has a wholly owned subsidiary, Midland Receivables 98-1 Corporation, which is not consolidated, but is recorded as an investment in retained interest on the accompanying consolidated statements of financial condition. The receivable portfolios consist primarily of charged-off domestic consumer credit card receivables purchased from national financial institutions, major retail credit corporations, and resellers of such portfolios. Acquisitions of receivable portfolios are financed by operations and by borrowings from third parties.

We have been in the collection business for 50 years and started purchasing portfolios for our own account approximately 13 years ago. We purchase charged-off credit card receivables and, to a lesser extent, other consumer receivables, including auto loan deficiencies and general consumer loans. From our inception through December 31, 2003, we have invested over $285.4 million to acquire 7.3 million consumer accounts with a face value of approximately $12.7 billion.

In May 2000, we acquired selected assets of West Capital Financial Services Corp., which also purchased defaulted receivables portfolios. At that time, West Capital's management team took over the operations of our business. Since then, this management team has refined our purchasing methodologies, significantly expanded and enhanced our collection strategies, improved our financial condition and returned Encore to profitability.

Since new management took over in mid-2000, we have collected $108.5 million through December 31, 2003 from the portfolios we purchased for $39.0 million in 2001; $118.5 million through December 31, 2003 from the portfolios we purchased for $62.5 million in 2002; and $59.0 million through December 31, 2003 from the portfolios we purchased for $89 8 million in 2003.

We purchase discrete pools of consumer receivables directly from credit card originators and other lenders, as well as from a variety

of resellers. We have established certain relationships that allow us to purchase portfolios directly through negotiated transactions, and we participate in the auction-style purchase processes that typify our industry. In addition, we enter into "forward flow" arrangements in which we agree to buy receivables that meet agreed upon parameters over the course of the contract term. Since mid-2000, we have purchased pools of consumer receivables from thirty credit originators and resellers.

We evaluate each portfolio for purchase using our proprietary valuation and underwriting processes developed by our in-house team of statisticians. Unlike many of our competitors which we believe often base their purchase decisions primarily on numerous aggregated portfolio-level factors, including the lender/originator, the type of receivables to be purchased, or the number of collection agencies the accounts have been placed with previously, we base our purchase decisions primarily on our analysis of the specific accounts included in a portfolio. Based upon this analysis, we determine a value for each account, which we aggregate to produce a valuation of the entire portfolio. We believe this capability allows us to perform more accurate valuations of receivables portfolios. In addition, we have successfully applied this methodology to other types of receivables, such as auto loan deficiencies and consumer loans.

Generally, our objective is to purchase portfolios at a price that allows us to recoup at least 85% of our purchase price within 12 months, and at least 2.7 times our purchase price over 54 months, for that portion we do not sell at the time of purchase. A substantial majority of our portfolios purchased since the arrival of the new management team in mid-2000 have returned more than 85% of their purchase price within a year, excluding cash generated from selected sales of accounts.

After we purchase a portfolio, we continuously refine our analysis of the accounts to determine the best strategy for collection. As with our purchase decisions, our collection strategies are based on account level criteria. Our collection strategies include:

- outbound calling, driven by proprietary predictive software, by our own sizable collection workforce located at our two call centers;
- the use of multiple third party networks of collection attorneys to pursue legal action where appropriate;
- direct mail campaigns coordinated by our in-house marketing group;
- the transfer of accounts to a credit card provider, generating a payment to us; and
- the sale of accounts where appropriate.

By applying these multiple collection processes in a systematic manner, we have greatly increased our collection effectiveness and reduced our total operating expense per dollar collected. Total operating expense per dollar collected was $0.39 for the year ended December 31, 2003, an improvement from $0.43 in the year ended December 31, 2002 and $0.56 in the year ended December 31, 2001. For the year ended December 31, 2003, we collected a monthly average of $23,385 per average active employee. For the year ended December 31, 2002, we collected a monthly average of $21,656 per average active employee, as compared to a monthly average of $12,875 per average active employee for the year ended December 31, 2001.

Investors wishing to obtain more information about Encore Capital Group, Inc. may access our Internet site (www.encorecapitalgroup.com) that allows access to relevant investor related information such as SEC filings, analyst coverage and earning estimates, press releases, featured articles, an event calendar, and frequently asked questions.

Our Industry

The receivables management industry is large and growing rapidly, driven by increasing levels of consumer debt, higher default rates, and increasing use of third-party providers by credit originators to collect their defaulted receivables. At December 31, 2003, consumer credit, which excludes mortgages, was $2.0 trillion, up 3.9% from December 31, 2002. Consumer credit grew at an 8.3% compounded annual rate between 1992 and 2002. The Federal Reserve Board estimates that consumer credit charge-offs totaled $57.2 billion during the third quarter of 2003, representing 2.9% of all consumer credit outstanding as of September 30, 2003. Consumer credit charge-offs grew at a 12.1% compounded annual rate between 1992 and 2002. Revolving credit, a subset of consumer credit, which includes credit cards, rose 2.6% to $742.5 billion in December 2003 from December 2002. Revolving credit is the fastest growing component of consumer credit, growing at an 11.0% compounded annual rate between 1992 and 2002. According to the Federal Reserve Board, for the third quarter of 2003, the credit card charge-off rate was 5.2%, down from 5.7% in the third quarter of 2002. Revolving credit charge-offs reached $44.3 billion in 2002, growing at a 14.2% compounded annual rate

between 1992 and 2002.

Historically, credit originators have sought to limit credit losses either through using internal collection efforts with their own personnel or outsourcing collection activities to accounts receivable management providers. Credit originators that have outsourced the collection of defaulted receivables have typically remained committed to third-party providers as a result of the perceived economic benefit of outsourcing and the resources required to reestablish the infrastructure required to support in-house collection efforts. Credit originators' outsourced solutions include selling their defaulted receivables for immediate cash proceeds and placing defaulted receivables with an outsourced provider on a contingent fee basis while retaining ownership of the receivables.

The accounts receivable industry is highly fragmented, with approximately 6,000 collection companies in the United States. Most of these collection companies are small, privately owned companies that collect for others for a contingent fee. We believe that there are fewer than fifteen to twenty large companies (many of which remain privately-owned) that purchase the receivables and collect on them for their own account.

Our Strengths

Since the new management team took over in mid-2000, we have substantially refined our purchasing methodologies, expanded our collection strategies, improved our balance sheet and became consistently profitable. We believe that these results are a product of the following strengths and competitive advantages:

Empirically Based and Technology-Driven Business Processes. We have assembled a team of statisticians, business analysts and software programmers that has developed proprietary valuation models, software and other business systems that guide our portfolio purchases and collection efforts. Our information technology department has developed and continually updates sophisticated software that manages the movement of data, accounts and information throughout the company. These proprietary systems give us the flexibility, speed and control to capitalize on business opportunities.

Account-Based Portfolio Valuation. We analyze each account within a portfolio presented to us for purchase to determine the likelihood and expected amount of payment. The expectations for each account are then aggregated to arrive at a valuation for the entire portfolio. Our valuations are derived in large part from information accumulated on approximately 4.8 million accounts acquired since mid-2000.

Dynamic Collections Approach. Over the past three years, we have dramatically reduced our dependence on general outbound calling by expanding our collection strategies to include direct mail campaigns, greater use of legal actions, account sales, and a relationship with a national credit card company to provide for account balance transfers. Moreover, because the status of individual debtors changes continually, once each quarter we re-analyze all of our accounts with refreshed external data, which we supplement with information gleaned from our own collection efforts. We change our collection method for each account accordingly.

Experienced Management Team. Our management team has considerable experience in financial, banking, consumer and other industries, as well as the collections industry. We believe that the expertise of our executives obtained by managing in other industries has been critical to the enhancement of our operations. Our management team has created a culture of new ideas and progressive thinking, coupled with the increased use of technology and statistical analysis.

Ability to Hire, Develop and Retain Productive Collectors and Key Employees. We place considerable emphasis on hiring, developing and retaining effective collectors and other employees who are key to our continued growth and profitability. As a result of ongoing training, compensation incentives and our progressive corporate culture, we believe that we have been able to achieve a retention rate that is higher than typical for our industry.

Large Database of Consumer Information From our inception through December 31, 2003, we acquired approximately 7.3 million accounts. We utilize a significant portion of the data from these accounts in our account-level valuation techniques employed in both the acquisition and management of accounts.

Our Strategy

To enhance our position in the industry, we have implemented a business strategy that emphasizes the following elements:

Implement New and Refine Existing Collection Channels We continually refine our collection processes, and evaluate new collection strategies, such as strategic outsourcing, to further supplement our traditional call center approach. We believe that our multiple and dynamic approach to collections increases our opportunity to achieve enhanced returns on our investments.

Leverage Expertise in New Markets We believe that our internally developed underwriting and collection processes can be extended to a variety of charged-off consumer receivables in addition to charged-off credit card receivables. We intend to continue to leverage our valuation, underwriting and collection processes to other charged-off receivables markets, including auto loan deficiencies and general consumer loans. We believe that these markets may be less competitive, and therefore may offer more favorable pricing and higher margin opportunities. To date, our purchases of auto loan deficiencies and general consumer loans have performed to expectations.

Increase Our Negotiated Transactions We have purchased portfolios from a number of credit originators and other sources. We believe that we have earned a reputation as a reliable purchaser and collector of defaulted consumer receivables portfolios, which helps to preserve the reputation of the credit originator. We intend to leverage our industry relationships and reputation to increase purchases through negotiated agreements, including forward flow contracts, and to reduce our reliance on auctions.

Improve Overall Cost of Funds Recently, we have taken a number of steps to improve our balance sheet, and are now exploring new financing arrangements with the goal of continuing to improve our balance sheet, lowering our cost of funds, and thereby improving our profitability and return on equity.

Continue to Build Our Data Management and Analysis Capabilities We are continually improving our technology platform and our pricing, underwriting and collection processes through software development, statistical analysis and experience.

Consider Complementary Acquisitions We intend to be opportunistic, and may pursue the acquisition of complementary companies to add to our expertise in new markets, add capacity, and provide us with additional portfolios to service.

Acquisition of Receivables

Once a portfolio purchase has been approved by our investment committee and the terms of the sale have been agreed to with the portfolio seller, the acquisition is documented in an agreement that contains customary terms and conditions. Provisions are incorporated for bankrupt, disputed, fraudulent or deceased accounts and, typically, the credit originator either agrees to repurchase these accounts or replace them with acceptable replacement accounts within certain time frames.

We maintain detailed static pool analysis on each portfolio that we have acquired, capturing collections, revenue, expense and other items for further analysis. In addition, our performance data set is continually updated and our valuation models are refined quarterly to capture the most current performance data.

As of December 31, 2003, we had two forward flow agreements under which we purchase charged-off receivables from the seller/originator on a periodic basis at a set price over a specified time period. Each of the agreements is cancelable by either party upon 60 days written notice without penalty. For the year ended December 31, 2003, we paid $32.8 million for receivables portfolios under forward flow agreements, which represented 36.6% of the $89.8 million in portfolio investments for the year. For the year ended December 31, 2002 we paid $12.4 million for receivable portfolios under forward flow agreements, which represented 19.8%

of the $62.5 million in portfolio investments for the year. As part of our pre-purchase procedures, we obtain a representative test portfolio to evaluate and compare the characteristics of each portfolio to the parameters set forth in the agreement prior to purchase.

The following table summarizes the average age since charge-off of our portfolios at time of purchase after mid-2000 when the new management team took control. This table excludes all receivables portfolios purchased prior to May 22, 2000, which as of December 31, 2003 consists of approximately 2.5 million accounts with an original face value of approximately $2.7 billion and remaining book value of approximately $2.2 million (*in thousands*):

Age at Purchase		Remaining Book Value[1]	%[2]
Purchases after May 22, 2000			
0-6 Months		$ 34,671	38.4%
7-12 Months		12,629	14.0
13-18 Months		22,284	24.6
19-24 Months		7,677	8.5
25-30 Months		2,588	2.9
31-36 Months		3,484	3.9
37+ Months		4,751	5.2
	Total	$ 88,084	97.5%

1 Remaining book value at December 31, 2003

2 Percentages are calculated based on our entire portfolio of receivables, including receivables purchased prior to May 22, 2000 and our investment in the retained interest

Collection Strategies

After we purchase a portfolio, we continuously refine our analysis to determine the most effective collection strategy to pursue. Through our proprietary internally-developed collection software we evaluate a number of variables to determine collection strategies for each account. These strategies consist of:

- *Call Centers* Generally, accounts with a higher likelihood of collection are called by collectors in our call centers in San Diego and Phoenix. Our collections department is divided into groups each consisting of three collection managers supervising approximately 36 collectors. Collectors are trained to use a friendly, but firm approach to assess the willingness of the customer to pay. They attempt to work with customers to evaluate sources and means of repayment to achieve a full or negotiated lump sum settlement or develop payment programs customized to the individual's ability to pay. In some cases, collectors advise the debtors of alternative sources of financing to pay off their debt, such as a home equity line of credit. In cases where a payment plan is developed, collectors encourage debtors to pay through auto-payment arrangements. We also accept a variety of payment methods including checks, the Western Union Quick Collect® system, credit and debit cards, and wire transfers.
- *Legal Action* We generally outsource those accounts where it appears the debtor is able, but is unwilling to pay. We utilize lawyers that specialize in collection matters, paying them a contingency fee on amounts collected. This process is managed by our Legal Outsourcing Department. We recently completed the process of changing how we interface with our attorney network. We expect this change will improve our efficiency in placing accounts with the attorneys as well as enhance our data integrity and warehousing capabilities.

- Recovery Collectors. Prior to sending accounts to a law firm, a specialized internal group of collectors communicates our intention to have a lawyer evaluate the suitability of the account for litigation if payment arrangements cannot be established. These collectors have higher collection rates than the "core" collectors in the call center.

- *Direct Mail* We have an in-house marketing team that develops innovative mail campaigns. The mail campaigns generally offer targeted debtors discounts on their balance owed to encourage settlement of their accounts and provide us with a low cost recovery method. This allows us to actively penetrate the segment of the portfolio that would not qualify for our outbound calling or legal action strategies
- *Sale* We believe our ability to purchase large portfolios enables us to sell a portion to buyers at a premium price. In addition, we sell, on a forward flow basis, all accounts in which the debtor has filed for protection under Chapter 13 of the United States Bankruptcy Code. Furthermore, we periodically sell accounts after we have determined that additional recovery efforts are not warranted.
- *Account Balance Transfer* We may transfer to our credit card partner accounts with a low expected value or those for which collection efforts have failed. The credit card partner may offer the debtor the opportunity to put the balance on a credit card. If the account is transferred we receive an agreed upon payment. We retain the ownership of and the ability to collect on the charged-off accounts that the card issuer has solicited until a successful balance-transfer has occurred
- *Skip Tracing* If, when a collector calls an account, the phone number proves inaccurate, or if current contact information for a debtor is not available at the time of account purchase, then the account is automatically routed to our database skip tracing process. We currently use eight different companies to provide phone numbers and addresses. We are able to process large volumes of accounts in a relatively short period of time. To ensure we do not continually call inaccurate numbers, a database has been established to track all phone numbers received on an account. If we receive a phone number from one of our outside partners that has proven to be inaccurate in the past, we do not add it to our system.

- *Inactive* For accounts where the prospects of collection seem remote–for example, the debtor is currently unemployed, overburdened by debt, incarcerated, or deceased – no collection method of any sort is assigned at that time. We try to use our collection resources wisely and efficiently by not wasting resources on accounts where the prospects of collection are remote.

Because the status of debtors changes continually, we re-analyze all of our accounts each quarter with refreshed credit bureau data, which we supplement with information gleaned from our own collection efforts. As circumstances dictate, we change our collection method for each account accordingly. We work the accounts we deem collectible over an extended period of time to improve our return on investment.

Recruiting and Training of Collectors

As of December 31, 2003, we employed 383 experienced collectors, 124 inexperienced collector trainees, and 74 management personnel within the collection workforce. Experienced collectors include those in the collection workforce employed as of January 1, 2003 and who were not part of our Employee Development Group (EDG). Inexperienced collectors are those in the collection workforce who were part of the EDG on January 1, 2003 plus all new hires in 2003. We believe our approach to hiring, training and retaining the collector workforce is unique and is aligned with our corporate goals. We seek to hire individuals who not only can collect, but will also be flexible when the company makes changes to account workflows and support our goal of always improving

our collection processes.

Prospective collectors go through an extensive interviewing process that requires them to fill out a job questionnaire, interview with professional recruiters, take a basic mathematical test, go through a criminal background screen, sit on the phone with one of our existing employees for 30 minutes and pass a behavioral test designed to predict a job fit. The behavioral test was developed in partnership with an outside psychological testing firm and targets those individuals who have characteristics similar to our established collector workforce. This test was implemented in the third quarter of 2002 and reduced attrition in the collector trainees during the first six months by almost 50%.

Once hired, all new collectors go through a thorough 4-week training process. During this period, they are taught our collection system, the Fair Debt Collection Practices Act ("FDCPA"), negotiation skills and queue management. Each collector must pass a comprehensive test on the FDCPA and other state laws before graduating.

After graduation, each individual is placed in our Employee Development Group. This group consists of inexperienced collectors, most of whom are in their first 6 months of employment. Our focus in this area is to build confidence in the new collectors and to support their growth with extensive management attention. Our manager-to-collector ratio target for this group is 1 to 10. We set up incentives to encourage personal growth through development of solid work habits and refined individual skills that will promote long-term success rather than penalize employees for not achieving quick performance levels. We believe this approach motivates the new collectors to learn and perform.

Once collectors in the Employment Development Group are able to show consistent performance by completing the required proficiency levels, they are transferred to our general workforce, where they are organized into teams of approximately 36 people with 3 managers. The larger team environment was established specifically to ensure management coverage throughout the day and to make sure there is adequate coverage during vacations. Our general collector workforce incentive plan has three components: base pay, which ranges from $2,250 to $3,500 per month; variable individual compensation; and team bonus. Top collectors earn more than $90,000 per year, with the average collector earning approximately $40,225 per year. The variable component of the collector's salary is based on a rolling 90-day period of time to ensure consistent performance.

Technology Platform

We believe one of our competitive advantages is the robust information management system we have developed. This system is integrated into all areas of our business and moves large amounts of data and information throughout the company as needed. In addition, it provides us with the flexibility to act upon up-to-date account information that allows us to continually enhance our business models to improve our collection efforts. We have an in-house staff of 16 programmers who create the functionality required to perform the tasks. Some examples include:

- an interactive query tool that selects a population of debtors for a mail campaign, splits the accounts into production cells and creates the output file for our mail vendor;
- an automated bankruptcy process that takes weekly electronic updates from our monitoring service, segments the accounts by bankruptcy chapter and places them in a queue for sale or follow-up or removes the account from the active process entirely;
- a phone number management system that tracks all phone numbers obtained for a customer, the source, the reason for removal (if any) and the number of attempts made to contact the customer at that number;
- a distribution tool that takes daily credit bureau activity files and sends automatic letters and places the accounts in collector queues;
- a queue management tool that ensures each collector's queue is worked regularly, stays within pre-established limits and is recycled on a bi-monthly schedule; and
- a dynamic extraction tool that culls accounts and electronically places them with legal firms across the country, according to a flexible set of hierarchical priorities.

Our collection software resides on an IBM iSeries, which was upgraded in July 2003. The hardware platform currently manages our approximately 7.3 million accounts and can be expanded to manage twice this number of accounts in the future without an additional upgrade, giving us extremely high levels of reliability and scalability.

We maintain a Microsoft Windows® 2000 based network that supports our back-office software including the human resource management application Perspectives, MAS 200® accounting software and ADP payroll system.

We use a Sun Microsystems™ based Concerto predictive dialing system and our analysts work with our SAS® quantitative analysis software on a Unix® server.

The application software and the network are backed up daily and kept offsite in a fireproof vault. We have a disaster recovery plan that was developed in conjunction with IBM and an agreement with Sungard Data Systems Inc. to provide equipment and facilities. In addition, we have an 850-gallon diesel generator capable of running our Phoenix facility, where the iSeries resides, in case of an extended power failure.

Competition

The consumer credit recovery industry is highly competitive and fragmented. We compete with a wide range of collection companies and financial services companies, which may have substantially greater personnel and financial resources than we do. We also compete with traditional contingency agencies and in-house recovery departments. Competitive pressures affect the availability and pricing of receivables portfolios, as well as the availability and cost of qualified recovery personnel. In addition, some of our competitors may have signed forward flow contracts under which originating institutions have agreed to transfer charged-off receivables to them in the future, which could restrict those originating institutions from selling receivables to us. We believe some of our major competitors, which include companies that focus primarily on the purchase of charged-off receivables portfolios, have continued to diversify into third party agency collections and into offering credit card and other financial services as part of their recovery strategy.

When purchasing receivables, we compete primarily on the basis of the price paid for receivables portfolios, our ability to be a reliable funder of prospective portfolios, and the quality of services that we provide. There continues to be consolidation of issuers of credit cards, which have been a principal source of receivable purchases. This consolidation has limited the sellers in the market and has correspondingly given the remaining sellers increasing market strength in the price and terms of the sale of credit card accounts.

Trade Secrets and Proprietary Information

We believe several components of our computer software are proprietary to our business. Although we have neither registered the software as copyrighted software nor attempted to obtain a patent related to the software, we believe that the software is protected as our trade secret. We have taken actions to establish the software as a trade secret, including informing employees that the software is a trade secret and making the underlying software code available only on an as needed basis. In addition, people who have access to information we consider proprietary must sign confidentiality agreements.

Government Regulation

In a number of states we must maintain licenses to perform debt recovery services and must satisfy related bonding requirements. We believe that we have satisfied all material licensing and bonding requirements and are in compliance with all material government regulations.

The FDCPA and comparable state statutes establish specific guidelines and procedures, which debt collectors must follow when communicating with customers, including the time, place and manner of the communications. It is our policy to comply with the

provisions of the FDCPA and comparable state statutes in all of our recovery activities, even though we may not be specifically subject to these laws. Our failure to comply with these laws could have a material adverse effect on us if they apply to some or all of our recovery activities. In addition to the FDCPA, significant federal laws applicable to our business include the following:

- Truth-In-Lending Act;
- Fair Credit Billing Act;
- Equal Credit Opportunity Act;
- Fair Credit Reporting Act;
- Electronic Funds Transfer Act;
- U.S. Bankruptcy Code;
- Gramm-Leach-Bliley Act; and
- Regulations that relate to these Acts

Additionally, there may be comparable statutes in those states in which customers reside or in which the originating institutions are located. State laws may also limit the interest rate and the fees that a credit card issuer may impose on its customers, and also limit the time in which we may file legal actions to enforce consumer accounts.

The relationship between a customer and a credit card issuer is extensively regulated by federal and state consumer protection and related laws and regulations. While we are not a credit card issuer, these laws affect some of our operations because the majority of our receivables were originated through credit card transactions. The laws and regulations applicable to credit card issuers, among other things, impose disclosure requirements when a credit card account is advertised, when it is applied for and when it is opened, at the end of monthly billing cycles, and at year-end. Federal law requires, among other things, that credit card issuers disclose to consumers the interest rates, fees, grace periods, and balance calculation methods associated with their credit card accounts. Some laws prohibit discriminatory practices in connection with the extension of credit. If the originating institution fails to comply with applicable statutes, rules, and regulations, it could create claims and rights for the customers that would reduce or eliminate their obligations under their receivables, and have a possible material adverse effect on us. When we acquire receivables, we generally require the originating institution to contractually indemnify us against losses caused by its failure to comply with applicable statutes, rules, and regulations relating to the receivables before they are sold to us.

Federal statutes further provide that, in some cases, consumers cannot be held liable for, or their liability is limited with respect to, charges to the credit card account that were a result of an unauthorized use of the credit card. These laws, among others, may give consumers a legal cause of action against us, or may limit our liability to recover amounts owing with respect to the receivables, whether or not we committed any wrongful act or omission in connection with the account.

Recently enacted state and federal laws concerning identity theft, privacy, the use of automated dialing equipment and other consumer protection laws impose requirements or restrictions on collection methods or our ability to enforce and recover certain debts. These requirements or restrictions could adversely affect our ability to enforce the receivables.

The laws described above, among others, as well as any new laws, rules or regulations, may adversely affect our ability to recover amounts owing with respect to the receivables.

Legal Department
Our legal department manages corporate legal matters, including litigation management, contract preparation and review, regulatory and statutory compliance, obtaining and maintaining state licenses and bonds, and dispute and complaint resolution. As of December 31, 2003, this department consisted of three full-time attorneys and one full-time paralegal.

The legal department helps to develop guidelines and procedures for recovery personnel to follow when communicating with a customer or third party during our recovery efforts. The legal department assists our training department in providing employees with extensive training on the FDCPA and other relevant laws. In addition, the legal department researches and provides collection and recovery personnel with summaries of state statutes so that they are aware of applicable time frames and laws when attempting to recover an account. It meets with other departments to provide legal updates and to address any practical issues uncovered in its review of files referred to the department.

Employees
As of December 31, 2003, we had 716 employees, of which 581 were involved in the collection workforce and 135 were involved in other functions. The additional 135 employees were in the following departments:

- 16 employees manage our other collections strategies such as legal outsourcing and direct mail;
- 21 human resources personnel, including 6 staff members dedicated to the training needs of our collectors;
- 15 employees dedicated to the analytical and transactional aspects of all of our portfolio purchases and sales efforts;
- 18 employees support our legal and compliance efforts;
- 61 employees support our analytic and technology capabilities, including 4 statisticians, 22 in the accounting/finance organization and 35 information technology employees, 16 of whom are programmers; and
- 4 executives.

None of our employees is represented by a labor union. We believe that our relations with our employees are good.

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Item 2 – Properties

We service our customers from two facilities. Our larger facility is located in Phoenix, Arizona. Designed to accommodate up to 600 employees, at December 31, 2003, the facility housed 431 employees. We lease the Phoenix facility, which is approximately 62,000 square feet, for a current monthly amount of $28,000; this lease expires in 2008. We also lease a facility in San Diego, California, which contains not only additional collection operations, but also serves as our corporate headquarters. This facility is approximately 33,000 square feet and is designed to accommodate up to 325 employees. It housed 285 employees at December 31, 2003. The San Diego facility lease payment totals $45,505 per month and the lease expires in October 2004. The Company is currently in negotiations with respect to replacement facilities following the expiration of the San Diego facility lease.

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Item 3 — Legal Proceedings

The FDCPA and comparable state statutes may result in class action lawsuits, which can be material to our business due to the remedies available under these statutes, including punitive damages.

On May 28, 2002, a complaint was filed by plaintiff Lana Waldon in the United States District Court for the Northern District of Texas against our wholly owned subsidiary Midland Credit and two unaffiliated financial institutions. The plaintiff's second amended complaint purported to assert claims for alleged violations of (i) the Texas Debt Collection Act and the Texas Deceptive Trade Practices Act on behalf of a putative class of Texas residents allegedly similarly situated, and (ii) the Fair Debt Collection Practices Act on behalf of a nationwide putative class of persons allegedly similarly situated. Generally, the second amended complaint alleged that mailings related to a credit card balance transfer program are deceptive and misleading. The second amended complaint sought actual, statutory and treble damages in an amount to be determined, together with pre-judgment and post-judgment interest, attorneys' fees, and preliminary and permanent injunctions enjoining defendants from making offers or distributing materials substantially similar to the mailings that are the subject of the second amended complaint, plus certain other relief. Our co-defendants, including a large financial institution, accepted our defense in this case. This case was settled at no cost to us and dismissed on December 16, 2003 with a full release by the plaintiff of all claims and liability against Midland Credit and related entities.

There are a number of additional lawsuits or claims pending or threatened against us. In general, these lawsuits or claims have arisen in the ordinary course of business and involve claims for actual damages arising from alleged misconduct of our employees or alleged improper reporting of credit information by the us Although litigation is inherently uncertain, based on past experience; the information currently available; and the possible availability of insurance and/or indemnification from originating institutions in some cases, we do not believe that the currently pending and threatened litigation or claims will have a material adverse effect on our consolidated financial statements. However, future events or circumstances, currently unknown to us, may determine whether the resolution of pending or threatened litigation or claims will ultimately have a material effect on our consolidated financial statements in any future reporting periods.

We do not believe that contingencies for ordinary routine claims, litigation and administrative proceedings and investigations incidental to our business will have a material adverse effect on our consolidated financial statements.

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Item 4 — Submission of Matters to a Vote of Security Holders

On November 18, 2003, the Company held its Annual Meeting of Stockholders. At the Annual Meeting, Raymond Fleming, Carl C. Gregory, III, Neville J. Katz, Eric D. Kogan, Alexander Lemond, Richard A. Mandell, Peter W May, Nelson Peltz and Robert M. Whyte were elected to serve as Directors.

The votes for the election of Directors is set forth below:

Name of Nominee	Votes For	Votes Against	Votes Withheld	Abstentions
Raymond Fleming	14,291,238	107,770	0	0
Carl C. Gregory, III	14,291,238	107,770	0	0
Neville J. Katz	14,291,238	107,770	0	0
Eric D. Kogan	14,288,338	107,770	2,900	0
Alexander Lemond	14,291,238	107,770	0	0
Richard A. Mandell	14,291,238	107,770	0	0
Peter W. May	14,288,338	107,770	2,900	0
Nelson Peltz	14,291,238	107,770	0	0
Robert M Whyte	14,291,238	107,770	0	0

At the Annual Meeting, the stockholders also approved proposal 2, ratifying the selection of the Company's independent auditors. The votes for proposal 2 were as follows:

	Votes For	Votes Against	Votes Withheld	Abstentions
Proposal 2	14,272,388	102,770	0	23,850

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PART II

Item 5 — Market for the Registrant's Common Equity Securities and Related Stockholder Matters

Our common stock is traded on the Nasdaq Stock Market's National Market under the symbol "ECPG." Prior to July 21, 2003, our stock traded on the OTC Electronic Bulletin Board under the symbol "ECPG.OB" (and before February 2002, it traded under the symbol "MCMC.OB").

While on the OTC, trading in our stock was often sporadic with a relatively low volume of shares traded. Quotations of the OTC reflect inter-trader prices, without material mark-up, markdown or commission and may not necessarily represent actual transactions.

The high and low closing sales prices of the common stock, as reported by Nasdaq Stock Market's National Market and the OTC Electronic Bulletin Board for each quarter during our two most recent fiscal years are reported below:

	Market Price	
	High	Low
Fiscal Year 2002		
First Quarter	$0.80	$0.26
Second Quarter	$1.01	$0.70
Third Quarter	$1.20	$0.45
Fourth Quarter	$1.60	$0.75
Fiscal Year 2003		
First Quarter	$ 1.60	$ 1.05
Second Quarter	$ 9.70	$ 1.60
Third Quarter	$14.40	$ 8.99
Fourth Quarter	$15.10	$11.85

The closing price of Encore's common stock on February 10, 2004 was $15.49 per share and there were 142 holders of record, including 100 NASD registered broker/dealers, which hold 9,382,172 shares on behalf of their clients.

Use of Proceeds of Recent Public Offering

In October 2003, Encore completed a public offering of 3,000,000 shares of its common stock, with certain stockholders selling an additional 2,750,000 shares of Encore's common stock. The underwriters for the offering were Jefferies & Company, Inc., Brean Murray & Co., Inc. and Roth Capital Partners, LLC. The shares of common stock sold in the offering were registered under the Securities Act of 1933, as amended, on a Registration Statement on Form S-1, Registration Number 333-108423, which was declared effective by the Securities and Exchange Commission on September 26, 2003. All of the 3,000,000 shares sold by us were issued at a price of $11.00 per share. We received net proceeds from the offering of approximately $30.1 million, after deducting approximately $2.9 million in underwriters' fees and other offering fees and expenses. We used $7.3 million of the proceeds from the offering to repay the then outstanding $7.3 million principal amount senior note to an institutional investor (the "Senior Notes") (see Note 6 to the consolidated financial statements). We intend to use the balance of approximately $22.8 million of such net proceeds for working capital and general corporate purposes, which may include the acquisition of complementary companies.

Private Securities Issuances
On February 22, 2002, certain existing stockholders and their affiliates purchased one million shares of our Series A Convertible Preferred Stock at a price of $5.00 per share for an aggregate purchase price of $5.0 million. Pursuant to an agreement between the Company and the holders of the Series A Preferred Stock, all of the preferred shares were converted into 10,000,000 shares of our common stock simultaneously with the closing of the public offering of our common stock on October 1, 2003. The holders of the Series A Preferred Stock were paid accrued dividends to the conversion date in accordance with the terms of the Series A Preferred Stock, but did not pay or receive any other consideration in connection with the conversion.

Effective February 22, 2002, in connection with the forgiveness of $5.3 million of outstanding debt, the lender agreed to reduce its warrant position by 200,000 from 428,571 to 228,571, retaining the term and exercise price of $0.01 when originally issued in January 2000 in connection with the purchase of our 12% Series No. 1 Senior Notes (the "Senior Notes") to an institutional investor (see "Senior Notes" in Management's Discussion and Analysis of Financial Discussion and Results of Operations). Effective October 31, 2000, we issued an additional 5,241 warrants to the institutional investor pursuant to the anti-dilution provisions of the warrants. Concurrently with the closing of our public offering on October 1, 2003, all 233,812 warrants were exercised and we received $2,338 in payment of the aggregate exercise price.

In January 2000 we issued 100,000 warrants to an affiliated party that agreed to guarantee the Senior Notes. Effective October 31, 2000, we issued an additional 1,275 warrants to the affiliated party pursuant to the anti-dilution provisions of the warrants. On September 30, 2003, all 101,275 warrants were exercised and we received $1,013 in payment of the aggregate exercise price.

In December 2000, we issued 621,576 warrants to acquire our common stock at an exercise price of $1.00 per share. The warrants were granted in conjunction with the establishment of a $75.0 million secured financial facility (the "Secured Financing Facility") that expires on December 31, 2004. On December 8, 2003, all 621,576 warrants were exercised and we received $621,576 in payment of the aggregate exercise price.

From October 2000 through September 2001, we issued 250,000 warrants to acquire our common stock at an exercise price of $0.01 per share. The warrants were granted in conjunction with the establishment and extension of a $2.0 million stand-by line of credit. The stand-by line of credit expired December 31, 2001. In April 2002, all 250,000 warrants were exercised and we received $2,500 in payment of the aggregate exercise price.

No underwriters were involved in the foregoing issuances of our securities. Each of the issuances of these securities was exempt from registration under the Securities Act pursuant to Section 4(2) under the Securities Act as transactions by an issuer not involving a public offering. The recipients of the securities represented their intentions to acquire the securities for investment only and not with a view to or for sale in connection with any distribution thereof and appropriate legends were affixed to the certificates representing such securities issued in such transactions. All recipients had access to detailed financial and operating information about us.

Dividend Policy
We have never declared or paid dividends on our common stock and we anticipate that we will retain earnings to support operations and to finance the growth and development of our business. Therefore, we do not intend to declare or pay dividends on the common stock for the foreseeable future. The declaration, payment and amount of future dividends, if any, will be subject to the discretion of our board of directors, which may review our dividend policy from time to time. We may also be subject to additional dividend restrictions under future financing facilities.

Our Series A Convertible Preferred Stock carried a cumulative dividend, payable semi-annually, of 10.0% per annum. Dividends due on August 15, 2002, February 15, 2003 and August 15, 2003 were paid in cash. On October 1, 2003, concurrent with the Company's follow-on public offering, all the holders of the Series A Preferred Stock converted their shares into 10.0 million shares of common stock pursuant to an agreement executed between the holders of such shares and the Company. The holders of the Series A Preferred Stock were paid accrued and unpaid dividends totaling $63,889 to the conversion date in accordance with the terms of the Series A Preferred Stock, but did not pay or receive any other consideration with the conversion.

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Item 6 — Selected Consolidated Financial Data

This table presents selected historical financial data of Encore. This information should be carefully considered in conjunction with the consolidated financial statements and notes thereto appearing elsewhere in this report. The selected data in this section are not intended to replace the consolidated financial statements. The selected financial data (except for "Selected Operating Data" in the table below), as of December 31, 2001, 2000, and 1999 and for the years ended December 31, 2000 and 1999, were derived from our audited consolidated financial statements not included in this report. The Selected Operating Data are derived from the books and records of Encore.

The selected historical financial data, except for Selected Operating Data, as of December 31, 2003 and 2002 and for the years ended December 31, 2003, 2002 and 2001, were derived from our audited consolidated financial statements included elsewhere in this report. (*In thousands, except per share, percentages, and personnel data*):

	As Of And For The Years Ended December 31,				
	2003	2002	2001	2000	1999
Revenues					
Revenue from receivables portfolios [1]	$ 115,575	$ 80,961	$ 32,581	$ 15,434	$ 12,917
Revenue from retained interest	307	5,707	9,806	11,679	7,836
Servicing fees and related revenue	1,620	3,712	5,458	9,447	7,405
Total revenues	117,502	90,380	47,845	36,560	28,158
Operating expenses					
Salaries and employee benefits	39,286	35,137	27,428	23,423	18,821
Other operating expenses	11,335	7,934	5,708	6,211	3,479
Cost of legal collections	15,827	11,028	5,457	129	–
General and administrative expenses	6,509	6,314	5,750	5,458	3,019
Restructuring charges	–	–	–	1,388	–
Provision for portfolio losses	–	1,049	–	20,886[2]	–
Depreciation and amortization	2,023	2,453	2,481	2,154	964
Total operating expenses	74,980	63,915	46,824	59,649	26,283
Income (loss) before interest, other income, and income taxes	42,522	26,465	1,021	(23,089)	1,875
Interest expense	(20,479)	(18,592)	(10,945)	(7,829)	(2,166)
Other income (expense), net	7,380[3]	213	208	(69)	206
Income (loss) before income taxes	29,423	8,086	(9,716)	(30,987)	(85)
(Provision for) benefit from income taxes	(11,003)	5,703[4]	(1,149)	7,257	34
Net income (loss)	18,420	13,789	(10,865)	(23,730)[2]	(51)
Preferred stock dividends	(374)	(440)	–	–	–
Net income (loss) available to common shareholders	$ 18,046	$ 13,349	$ (10,865)	$ (23,730)[2]	$ (51)

	As Of And For The Years Ended December 31,				
	2003	2002	2001	2000	1999
Earnings (loss) per common share:					
Basic	$ 1.65	$ 1.82	$ (1.52)	$ (3.20)	$ (0.01)
Diluted	$ 0.88	$ 0.84	$ (1.52)	$ (3.20)	$ (0.01)
Weighted-average shares outstanding:					
Basic	10,965	7,339	7,161	7,421	5,989
Diluted	20,873	16,459	7,161	7,421	5,989
Cash flow data:					
Cash flows provided by (used in):					
Operating	$ 33,971	$ 24,690	$ 8,853	$ (15,831)	$ (3,405)
Investing	(19,472)	(11,158)	(21,773)	12,399	(59,491)
Financing	23,361	(14,192)	13,444	3,968	58,590
Selected operating data:					
Purchases of receivables portfolios, at cost	$ 89,834	$ 62,525	$ 39,030	$ 6,911[5]	$ 51,969
Growth in purchases, at cost [6]	43.7%	60.2%	464.8%	(86.7)%	109.9%
Gross collections for the period	$ 190,519	$ 148,808	$ 83,051	$ 66,117	$ 34,877
Gross collections growth for the period [6]	28.0%	79.2%	25.6%	89.6%	118.8%
Total active collectors at period end	507	435	419	336	NAV[7]
Total active employees at period end	716	611	583	523	585
Average active employees for the period	679	573	538	554	NAV[7]
Gross collections per average active employee for the period	$ 281	$ 260	$ 154	$ 119	NAV[7]
Total operating expenses per average active employee for the period	$ 110	$ 112	$ 87	$ 108[2]	NAV[7]
Total operating expenses to gross collections	39.4%	43.0%	56.4%	90.2%[2]	75.4%
Consolidated statements of financial condition data:					
Cash	$ 38,612	$ 752	$ 1,412	$ 888	$ 352
Restricted cash	842	3,105	3,053	2,468	2,939
Investment in receivables portfolios	89,136	64,168	47,001	25,969	57,473
Investment in retained interest	1,231	8,256	17,926	31,616	30,555
Total assets	138,285	89,974	77,711	71,101	101,540
Accrued profit sharing arrangement	12,749	11,180	2,378	–	–
Notes payable and other borrowings, net	41,178	47,689	69,215	53,270	47,418
Capital lease obligations	460	344	1,236	2,233	1,262
Total debt	41,638	48,033	70,451	55,503	48,680
Total liabilities	66,914	70,432	80,069	61,022	68,512
Total stockholders' equity (deficit)	71,371	19,542	(2,358)	10,079	33,028

1 Includes gains from whole portfolio sales totaling $0.3 million, $0.7 million, and $0.1 million for the years ended December 31, 2003, 2002, and 1999, respectively.

2 Includes impairment charges of $20.9 million against the carrying value of thirty-two receivable portfolios acquired in 1999 and 2000, which increased the operating expenses per average active employee for 2000 by $38,000 and

approximates 31.6% of gross collections for 2000.

3 Reflects a non-recurring net pre-tax gain totaling $7.2 million, recognized in the first quarter of 2003 upon settlement of a lawsuit against the seller of certain accounts. This resulted in an after tax net gain of $4.4 million or $0.21 per share on a fully diluted basis.

4 Reflects a benefit totaling $9.9 million or $0.60 per share on a fully diluted basis, recognized in 2002 resulting from our reinstatement of our net deferred tax asset.

5 Includes $2.0 million in receivables portfolios purchased as part of the West Capital acquisition.

6 Percentage is calculated by taking the current period amount less the prior period amount and dividing the result by the prior period amount.

7 NAV - This information is not available.

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Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations

The information in this section should be read in conjunction with our consolidated financial statements and notes to the consolidated financial statements beginning on page 67 and the Risk Factors beginning on page 58.

Results of Operations

Highlights

Our business and financial results improved significantly during 2003. Highlights of our year are as follows:

We completed a follow-on public offering of our common stock in October of 2003. We sold 3.0 million shares (certain selling stockholders sold an additional 2.75 million shares) and our net proceeds were approximately $30.1 million, increasing our total equity to approximately $63.3 million at the time of the offering.

For the year ended December 31, 2003 as compared to the same period in 2002:

- Gross collections increased 28.0% to $190.5 million;
- Revenues increased 30.0%, reaching $117.5 million;
- Operating expenses increased 17.3% to $75.0 million;
- Net income increased 33.6% to $18.4 million; and
- Cash flow from operations increased 37.6% to $34.0 million.

Our net income has grown, despite, among other things, a 22.8% growth in contingent interest expense to $16.0 million for the year ended December 31, 2003. Contingent interest expense relates to the sharing of residual collections with our Secured Financing Facility lender who has an exclusive relationship with us to finance credit card receivables purchases through December 2004. We have made moderate purchases of defaulted auto loans as part of our strategy to expand our activities into non-credit card markets.

Year Ended December 31, 2003 Compared to Year Ended December 31, 2002

The following table summarizes our collections, revenues, operating expenses, income before taxes, net income, and cash flows from operations (*in thousands*):

	Years Ended December 31,			
	2003	2002	$ Change	% Change
Gross collections	$ 190,519	$ 148,808	$ 41,711	28.0%
Revenue	$ 117,502	$ 90,380	27,122	30.0
as a percentage of gross collections	61.7%	60.7%		
Operating expenses	$ 74,980	$ 63,915	11,065	17.3
as a percentage of gross collections	39.4%	43.0%		
Income before taxes	$ 29,423	$ 8,086	21,337	263.9
as a percentage of gross collections	15.4%	5.4%		
Net income	$ 18,420	$ 13,789	4,631	33.6
as a percentage of gross collections	9.7%	9.3%		
Cash flows from operations	$ 33,971	$ 24,690	9,281	37.6
as a percentage of gross collections	17.8%	16.6%		

Collections

Gross collections for the year ended December 31, 2003 were $190.5 million compared to gross collections of $148.8 million for the year ended December 31, 2002, an increase of $41.7 million or 28%. The components of gross collections for the twelve months ended December 31, 2003 and 2002 are as follows:

	December 31, 2003	December 31 2002
Investment in receivable portfolios	$ 178,950	$ 124,388
Investment in retained interest	6,819	13,929
Gross collections for third parties	4,750	10,491
Total gross collections	$ 190,519	$ 148,808

The $41.7 million increase in gross collections reflects the continued leveraging of our workforce's intellectual capital. Gross collections grew by 28.0% while the size of our average workforce grew by 18.5% during the year ended December 31, 2003 compared to the prior year. Our high collector retention rates coupled with our innovative alternative collection strategies have resulted in an increase of 8.0% in monthly average collections to $23,385 from $21,656 per average employee during years ended December 31, 2003 and 2002, respectively. Our average monthly gross collections were $15.9 million and $12.4 million during the years ended December 31, 2003 and 2002, respectively, while our total employees averaged 679 for the year ended December 31, 2003 and 573 for the year ended December 31, 2002.

The $41.7 million increase in gross collections is derived primarily from new portfolios purchased since December of 2000 utilizing our Secured Financing Facility. Gross collections related to portfolios utilizing our Secured Financing Facility were $156.3 million for the year ended December 31, 2003, compared to gross collections of $101.1 million for the year ended December 31, 2002, an increase of $55.2 million or 54.6%.

Proceeds from a litigation settlement were not included in gross collections for the year ended December 31, 2003 (see Note 4 to the consolidated financial statements).

Revenues

Total revenues for the year ended December 31, 2003 were $117.5 million compared to total revenues of $90.4 million for the year ended December 31, 2002, an increase of $27.1 million, or 30.0%. The increase in total revenues is primarily the result of a $41.7 million or a 28.0% increase in gross collections from $148.8 million for the year ended December 31, 2002 compared to gross collections of $190.5 million for the year ended December 31, 2003. The increase is primarily from revenue from receivable portfolios, which increased $34.6 million or 42.8%, to $115.6 million from $81.0 million for the years ended December 31, 2003 and 2002, respectively. Revenue from the retained interest in securitized receivables declined by $5.4 million, from $5.7 million for the year ended December 31, 2002 to $0.3 million for the year ended December 31, 2003. This reflects declines in cash collections since the first quarter of 2003 in the underlying portfolios and the concurrent lowering of our expected yield on the retained interest from approximately 44.4% to 7.5% per annum. The portfolios within the retained interest were purchased as long ago as 1990, and therefore age, coupled with the recent decline in collection performance led to our conclusion that a lowering of the expected yield would be appropriate. The increase in revenue from receivable portfolios was further offset by a decrease in servicing fees of $2.1 million, a 56.4% decrease, from $3.7 million for the year ended December 31, 2002 to $1.6 million for the year ended December 31, 2003.

The $34.6 million increase in revenue from receivable portfolios for the year ended December 31, 2003 compared to the prior year is primarily attributable to new portfolios purchased during intervening quarters. During the year ended December 31, 2003, we purchased additional portfolios with a face value of $3.3 billion at a cost of $89.8 million, or 2.7% of face value. The portfolios purchased during 2003 provided $27.2 million of revenue during the year ended December 31, 2003.

We service a pool of charged-off consumer accounts on behalf of an unrelated third party. Servicing fees received under this arrangement were $1.6 million and $3.7 million for the twelve months ended December 31, 2003 and 2002, respectively. In February of 2003, we elected to return all exhausted receivables to the owner. We have, however, retained the servicing rights for those receivables remaining in active work queues and those placed with our attorney network. As a result of this action, we anticipate that the stream of service fee income related to these receivables will continue to decrease.

Significant estimates have been made by management with respect to the timing and amount of collections of future cash flows from receivable portfolios owned and those underlying the Company's retained interest. It is our policy, once every quarter, to evaluate each portfolio's actual collections against the forecast. Through September 30, 2003, we had not increased the total estimated cash flow for any portfolio; however, we have reduced the total estimated remaining cash flow in certain circumstances. For those portfolios whose actual cumulative collections exceeded the forecast, such excess amounts were subtracted from the future estimated collections in order to maintain the original forecast. Conversely, we have reduced the remaining collection forecasts on those portfolios that have not met our expectations for the six most recent months.

On purchases made since mid-2000, our gross collections, in the aggregate, have exceeded expectations. We have sought to develop the statistical support to help us determine whether the better than expected performance resulted from: (i) our collecting at a more rapid rate than originally forecast; (ii) our increasing our penetration of the portfolio and thus increasing the likelihood of collecting more than the original forecast; or (iii) some combination of both faster collections and additional penetration of the portfolio. Our Unified Collection Score ("UCS") model, recently developed to project these remaining cash flows, considers known data about the our customers' accounts, including, among other things, our collection experience, and changes in external customer factors, in addition to all data known when we acquired the accounts.

The UCS model was implemented effective October 1, 2003. We revised the projected collections for portfolios with carrying values totaling $72.2 million as of October 1, 2003, which represented 91.9% of the aggregate carrying value of our portfolios at that date. The change in our estimate of projected collections resulting from the application of the UCS model resulted in an increase in the aggregate total remaining gross collections for these portfolios by 36.9% as of December 31, 2003. The implementation of these revised forecasts resulted in an increase in the recognition of accretion revenue of $1.3 million and an increase in the accrual for contingent interest of $1.0 million for the fourth quarter of 2003. The net impact of the change in estimate was to increase fourth quarter pretax income by $0.3 million, net income by $0.2 million, and fully diluted earnings per share by $0.01. The reforecast of

collections resulted in expanding the budgeted life of these portfolios by an average of 13 months from an average remaining life of 31 months to a revised average remaining life of 44 months. The resulting ratio of revenues to collections for accruing portfolios for the year ended December 31, 2003 increased 84 basis points to 60.9% as a result of this adjustment. It further had the impact of increasing the aggregate annual effective interest rate on all accruing portfolios by 6.4 basis points to 119.7% for the quarter ended December 31, 2003.

Total revenue recognized related to portfolios worked is comprised of two components – those portfolios that have a book basis and which are on accrual basis, and those that have collected more than forecasted and have fully recovered their book value ("Zero basis portfolios"). The following table summarizes the revenue recognized from each of these sources for the following periods (*in thousands*):

	For the Years Ended December 31,			
Revenue component	**2003**	**2002**	**$ Change**	**% Change**
Accrual basis portfolios	$ 95,851	$ 76,043	$ 19,808	26.0%
Weighted average effective interest rate	140.5%	160.9%		
Zero Basis Portfolios	$ 19,724	$ 4,918	14,806	301.1
Total owned portfolio revenue	$ 115,575	$ 80,961	34,614	42.8
Total owned portfolio revenue as a percentage of our average aggregate investment in receivable portfolios	169.4%	171.3%		

For accrual basis portfolios, the weighted average annualized effective interest rate is the accrual rate utilized in recognizing revenue on our accrual basis portfolios. This rate represents the monthly internal rate of return, which has been annualized utilizing the simple interest method. The monthly internal rate of return is determined based on the timing and amounts of actual cash received and the anticipated future cash flow projections for each pool.

Collections on certain of our portfolios have recovered their entire budgeted forecast and therefore have a zero basis. The total owned portfolio revenue as a percentage of our average aggregate investment in receivable portfolios of 169.4% for the year ended December 31, 2003 is slightly lower than the 171.3% for the year ended December 31, 2002.

The following tables summarize the changes in the balance of the investment in receivable portfolios and the proportion of revenue recognized as a percentage of collections during the following periods (*in thousands*):

	For the Year Ended December 31, 2003			
	Accrual Basis Portfolios	**Cost Recovery Portfolios**	**Zero Basis Portfolios**	**Total**
Balance, beginning of period	$ 63,253	$ 915	$ –	$ 64,168

Purchases of receivable portfolios	88,809	1,025	–	89,834
Transfers of portfolios	(1,860)	1,860	–	–
Gross collections	(157,335)	(1,911)	(19,704)	(178,950)
Portion of Litigation Settlement proceeds applied to carrying value	(692)	–	–	(692)
Adjustments	(777)	(2)	(20)	(799)
Revenue recognized	95,851	–	19,724	115,575
Balance, end of period	$ 87,249	$ 1,887	$ –	$ 89,136
Revenue as a percentage of collections	60.9%	0.0%	100.0%	64.6%

	For the Year Ended December 31, 2002			
	Accrual Basis Portfolios	Cost Recovery Portfolios	Zero Basis Portfolios	Total
Balance, beginning of period	$ 45,671	$ 1,330	$ –	$ 47,001
Purchases of receivable portfolios	62,525	–	–	62,525
Transfers of portfolios	(1,490)	1,490	–	–
Gross collections	(118,614)	(856)	(4,918)	(124,388)
Adjustments	(882)	–	–	(882)
Provision for portfolio losses	–	(1,049)	–	(1,049)
Revenue recognized	76,043	–	4,918	80,961
Balance, end of period	$ 63,253	$ 915	$ –	$ 64,168
Revenue as a percentage of collections	64.1%	0.0%	100.0%	65.1%

The following table summarizes the changes in the balance of the retained interest and the proportion of revenue recognized as a percentage of collections during the following periods (*in thousands*):

	For the Years Ended December 31,	
	2003	2002
Balance, beginning of period	$ 8,256	$ 17,926
Gross collections	(6,819)	(13,929)
Amortization of unrealized gain	(513)	(1,448)
Revenue recognized	307	5,707
Balance, end of period	$ 1,231	$ 8,256
Revenue as a percentage of collections	4.5%	41.0%

The annualized effective interest rate for the retained interest was 7.5% for the year ended December 31, 2003 compared to 44.4% for the years ended December 31, 2002. During the first quarter of 2003, we lowered our expected yield on the retained interest based on our estimated net cash flows derived from both historical and projected collections

Operating expenses
Total operating expenses were $75.0 million for the year ended December 31, 2003, compared to $63.9 million for the year ended December 31, 2002, an increase of $11.1 million or 17.3% This increase is primarily volume-related, driven by a 28.0% increase in gross collections.

The largest component of total operating expenses is salaries (including bonuses) and employee benefits which increased by $4.2 million or 11.8% to $39.3 million for the year ended December 31, 2003 from $35.1 million for the year ended December 31, 2002. The 11.8% increase in salaries and benefits is the result of an increase in the average number of our employees. The average number of employees of 679 for the year ended December 31, 2003 grew by 106 or 18.5% from the 573 employees for the year ended December 31, 2002. Total salaries and benefits as a percentage of gross collections for the years ended December 31, 2003 and 2002 were 20.6% and 23.6%, respectively. Also included in salaries in the second quarter of 2002 is a $0.5 million settlement paid to a former executive officer.

We believe our success is directly related to our ability to attract and retain skilled employees. The retention rates of those experienced collectors employed at the beginning of the year and who remained employed through the end of the period were 79.0% and 81.0% for the years ended December 31, 2003 and 2002, respectively. The retention rates of inexperienced collectors (defined as those collectors in our training program at the beginning of the year, plus all new hires during the year and who remained employed through the end of the year) were 60.0% and 63.8% for the years ended December 31, 2003 and 2002, respectively.

Other operating expenses increased approximately $3.4 million, or 42.9%, to $11.3 million for the year ended December 31, 2003 from $7.9 million for the year ended December 31, 2002. The increase primarily reflects a $2.5 million increase to $4.7 million in direct mail campaign costs during the year ended December 31, 2003.

Gross collections through the legal channel amounted to $40.0 million for the year ended December 31, 2003, representing growth of 44.7% above the $27.6 million collected through this channel during the prior year. The cost of legal collections reflects those costs associated with the business channel dedicated to collecting on accounts that have been determined to be collectible, but which require tactics other than telephone or mail solicitation. The corresponding costs of legal collections amounted to $15.8 million or 39.5% of gross collections through this channel for the year ended December 31, 2003 as compared to the $11.0 million or 39.9% for the year ended December 31, 2002. The increase in the legal costs reflects an increased provision for uncollectible court costs of $2.2 million for the year ended December 31, 2003 as compared to $1.6 million for the prior year. The higher provision is based on our analysis of court costs that we have advanced, recovered, and anticipate recovering. The reserve of $3.6 million on court costs advanced of $4.9 million represents those costs that we believe will be ultimately uncollectible as of December 31, 2003.

General and administrative expenses were $6.5 and $6.3 million for the years ended December 31, 2003 and 2002, respectively. We have maintained consistent general and administrative expenses despite the increase in gross collections discussed above.

Depreciation expense of $2.0 million and $2.5 million for the years ended December 31, 2003 and 2002, respectively, also decreased modestly due to limited expenditures for capital items.

Interest expense
The following table summarizes our interest expense (*in thousands*):

	For the Years Ended December 31,			
	2003	2002	$ Change	% Change

Stated interest on debt obligations	$ 2,940	$ 3,859	$ (919)	(23.8)%
Amortization of loan fees and other loan costs	1,516	1,685	(169)	(10.0)
Contingent interest	16,023	13,048	2,975	22.8
Total interest expense	$ 20,479	$ 18,592	$ 1,887	10.1

For the year ended December 31, 2003, total interest expense including fees and amortization of other loan costs was $20.5 million on average borrowings for the period of $41.7 million, reflecting an effective interest rate of 49.1% for the period. The interest only portion (interest on debt obligations) of this total amounted to $2.9 million. For the year ended December 31, 2002, total interest expense including fees and amortization of other loan costs was $18.6 million on average borrowings of $55.8 million, reflecting an effective interest rate of 33.3% for the period. The interest only portion (interest on debt obligations) of this total amounted to $3.9 million. The remaining portions of interest expense consists primarily of contingent interest expense related to the sharing of residual collections with our Secured Financing Facility lender as well as amortization of loan fees and other loan costs.

We expensed $16.0 million and $13.0 million related to the sharing of residual collections with our Secured Financing Facility lender for the years ended December 31, 2003 and 2002, respectively, which was a $3.0 million or 22.8% increase in contingent interest expense. The $1.9 million increase in total interest expense consisted of the $3.0 million increase in total contingent interest expense offset primarily by a reduction in interest expense reflecting the repayment in full of two securitized receivable acquisition facilities and the revolving line of credit. These three facilities had a combined debt balance that totaled $16.2 million as of December 31, 2002, and were repaid in full during the second quarter of 2003 (see Notes 6 and 8 to consolidated financial statements) The Senior Notes totaling $7.3 million were repaid in full on October 1, 2003.

Other income and expense
For the year ended December 31, 2003, total other income was $7.4 million, compared to $0.2 million for the year ended December 31, 2002. We recorded a pretax net gain of $7.2 million in other income during the first quarter of 2003 related to a litigation settlement (see Note 4 to the consolidated financial statements).

Income taxes
For the year ended December 31, 2003, we recorded an income tax provision of $11.0 million, which is an effective rate of 37.4% of pretax income. For the year ended December 31, 2002, we recorded an income tax benefit of $5.7 million, reflecting an effective benefit of 70.5% of pretax income. During the fourth quarter of 2002, we determined that the utilization of net operating losses and other deferred tax assets was more likely than not, and therefore removed all but $0.2 million of the valuation allowance. The change in the valuation allowance resulted in the recognition of a current tax benefit in the amount of $9.9 million in the fourth quarter of 2002. This current tax benefit combined with a deferred tax expense, resulted in a net deferred tax benefit of $6.2 million for the fourth quarter of 2002 (see Note 9 to the consolidated financial statements).

Net Income
For the year ended December 31, 2003, we recognized net income of $18.4 million compared to net income of $13.8 million for the year ended December 31, 2002.

Supplemental Financial Information

The following table is a reconciliation of generally accepted accounting principles in the United States of America ("GAAP") income before taxes, net income and fully diluted earnings per share to income before taxes, net income and fully diluted earnings per share, excluding one-time benefits and other charges for the years presented. We believe that these non-GAAP financial measures provide useful information to investors about our results of operations because the elimination of one-time benefits and charges that are included in the GAAP financial measures results in a normalized comparison of certain key financial results between the periods presented. (*in thousands, except per share amounts*):

	Years Ended December 31,	
	2003	2002
Income Before Taxes		
GAAP, as reported	$ 29,423	$ 8,086
Gain on settlement of litigation [1]	(7,210)	–
Write off of deferred costs [2]	870	–
Income before taxes, excluding one-time benefit and charges	$ 23,083	$ 8,086
Percentage increase over prior period	185.5%	
Net Income		
GAAP, as reported	$ 18,420	$ 13,789
Gain on settlement of litigation [3]	(4,376)	–
Write off of deferred costs [4]	528	–
Benefit from restoration of net deferred tax assets [5]	–	(9,887)
Net income, excluding one-time benefits and charges	$ 14,572	$ 3,902
Percentage increase over prior period	273.4%	
Fully Diluted Earnings Per Share		
GAAP, as reported	$ 0.88	$ 0.84
Gain on settlement of litigation [3]	(0.21)	–
Write off of deferred costs [4]	0.03	–
Benefit from restoration of net deferred tax assets [5]	–	(0.60)
Fully diluted earnings per share, excluding one-time benefits and charges	$ 0.70	$ 0.24
Percentage increase over prior period	190.7%	

1 This is the result of a net pretax gain of $7.2 million associated with a litigation settlement during the first quarter of 2003 (see Note 4 to the consolidated financial statements).

2 This is the result of the pretax write-off of $0.9 million in deferred loans costs and a debt discount associated with the early retirement of our Senior Notes during the fourth quarter of 2003 (see Note 8 to the consolidated financial statements).

3 This is the result of a net after-tax gain of $4.4 million, or $0.21 per fully diluted share associated with a litigation settlement during the first quarter of 2003 (see Note 4 to the consolidated financial statements).

4 This is the result of the after-tax write-off of $0.5 million, or $0.03 per fully diluted share in deferred loans costs and a

debt discount associated with the early retirement of our Senior Notes during the fourth quarter of 2003 (see Note 8 to the consolidated financial statements).

5 This is the result of a change in the valuation allowance associated with our net tax assets as of December 31, 2002, which resulted in the recognition of a current tax benefit in the amount of $9.9 million, or $0.60 per fully diluted share during the year ended December 31, 2002 (see Note 9 to the consolidated financial statements).

Year Ended December 31, 2002 Compared to Year Ended December 31, 2001

The following table summarizes our collections, revenues, operating expenses, income before taxes, net income, and cash flows from operations (*in thousands*):

	For the Years Ended December 31,			
	2002	2001	$ Change	% Change
Gross collections	$ 148,808	$ 83,051	$ 65,757	79.2%
Revenues	$ 90,380	$ 47,845	42,535	88.9
as a percentage of gross collections	60.7 %	57.6 %		
Operating expenses	$ 63,915	$ 46,824	17,091	36.5
as a percentage of gross collections	43.0 %	56.4 %		
Income (loss) before taxes	$ 8,086	$ (9,716)	17,802	183.2
as a percentage of gross collections	5.4 %	(11.7)%		
Net income (loss)	$ 13,789	$ (10,865)	24,654	226.9
as a percentage of gross collections	9.3 %	(13.1)%		
Cash flows from operations	$ 24,690	$ 8,853	15,837	178.9
as a percentage of gross collections	16.6 %	10.7 %		

Collections

Gross collections for the twelve months ended December 31, 2002 were $148.8 million compared to gross collections of $83.0 million for the twelve months ended December 31, 2001, an increase of $65.8 million or 79.2%. The components of gross collections are as follows:

	For The Years Ended December 31,	
	2002	2001
Investment in receivable portfolios	$ 124,388	$ 49,429
Investment in retained interest	13,929	20,675
Collections for third parties	10,491	12,947
Total gross collections	$ 148,808	$ 83,051

The $65.8 million increase in gross collections reflects the continued leveraging of our workforce's intellectual capital. Gross collections grew 79.2% while the size of our average workforce grew 6.5% during the year ended December 31, 2002 compared to

the prior year. Our high collector retention rates coupled with our innovative alternative collection strategies have resulted in an increase of 68.2% in monthly average collections of $21,656 and $12,875 per average employee during the years ended December 31, 2002 and 2001, respectively. Our average monthly gross collections were $12.4 million and $6.9 million during the years ended December 31, 2002 and 2001, respectively, while our total employees averaged 573 for the year ended December 31, 2002 and 538 for the years ended December 31, 2001.

The increased collections are primarily derived from new portfolios purchased since December 2000 utilizing our Secured Financing Facility. Gross collections related to portfolios utilizing our Secured Financing Facility were $101.1 million for the year ended December 31, 2002, compared to gross collections of $21.3 million for the year ended December 31, 2001, an increase of $79.7 million or 375.0%.

Revenues

Total revenues for the twelve months ended December 31, 2002 were $90.4 million compared to total revenues of $47.8 million for the year ended December 31, 2001, an increase of $42.5 million or 88.9%. The increase is primarily due to revenue from receivables portfolios, which increased $48.4 million or 148.5%, to $81.0 million from $32.6 million for the twelve months ended December 31, 2002 and 2001, respectively. This increase is primarily the result of a 79.2% increase in total collections of $65.8 million from $83.0 million in 2001 to $148.8 million in 2002. Revenue from the retained interest in securitized receivables declined by $4.1 million, from $9.8 million for the year ended December 31, 2001. This reflects declines in cash collections in the underlying portfolios. The increase was further offset by a decrease in servicing fees and other related income of $1.8 million, a 32.0% decrease from $5.5 million for the year ended December 31, 2001 to $3.7 million for the year ended December 31, 2002.

The $48.4 million increase in revenue from receivables portfolios for the year ended December 31, 2002 compared to the year ended December 31, 2001 is primarily attributable to new portfolios purchased during the year ended December 31, 2002. During the year ended December 31, 2002, we acquired new portfolios with a face value of $2.8 billion at a cost of $62.5 million, which represented 2.23% of face value. The majority of these portfolios were purchased utilizing our $75.0 million Secured Financing Facility. These portfolios provided $28.0 million of revenue during 2002. In 2001, we purchased portfolios with a face value of $1.6 billion at a total cost of $39.0 million, which represented 2.51% of face value. These portfolios provided $38.1 million of revenue during 2002, which was an increase from $15.2 million of revenue during 2001. We acquired substantially all the assets of another financial services company, West Capital Financial Services Corp. ("West Capital"), in May 2000. The portfolios acquired in the West Capital transaction with a face value of $2.4 billion and a cost of $2.0 million generated $1.4 million in revenue during 2002 compared with $4.1 million in 2001, a decrease of $2.7 million. As we expected, revenues on all other portfolios decreased by $1.4 million during 2002 as compared to 2001. Furthermore, certain portfolios that were previously recorded on a cost recovery basis were returned to the accretion method and accounted for $0.9 million of the increase in revenue for the twelve months ended December 31, 2002. We also initiated whole portfolio sales during 2002. The net gain from this initiative totaled $0.7 million, which is reflected in Revenue from receivables portfolios.

We serviced a pool of charged-off consumer accounts on behalf of an unrelated third party. Servicing fees received under this arrangement were $3.7 million and $5.5 million for the years ended December 31, 2002 and 2001, respectively. In February 2003, we returned all exhausted receivables to the owner. We have, however, retained the servicing rights for those certain receivables in active work queues and those placed with our attorney network. As a result of this action, we anticipate that the stream of service fee income related to those receivables will continue to decrease.

The following tables summarize the changes in the balance of the investment in receivables portfolios and the proportion of revenue recognized as a percentage of collections during the following periods (*in thousands*):

	For the Year Ended December 31, 2002			
	Accrual Basis Portfolios	Cost Recovery Portfolios	Zero Basis Portfolios	Total
Balance, beginning of period	$ 45,671	$ 1,330	$ –	$ 47,001
Purchases of receivables portfolios	62,525	–	–	62,525
Transfers of portfolios	(1,490)	1,490	–	–
Gross collections	(118,614)	(856)	(4,918)	(124,388)
Provision for portfolio losses	–	(1,049)	–	(1,049)
Adjustments	(882)	–	–	(882)
Revenue recognized	76,043	–	4,918	80,961
Balance, end of period	$ 63,253	$ 915	$ –	$ 64,168
Revenue as a percentage of collections	64.1%	0.0%	100.0%	65.1%

	For the Year Ended December 31, 2001			
	Accrual Basis Portfolios	Cost Recovery Portfolios	Zero Basis Portfolios	Total
Balance, beginning of period	$ 20,406	$ 5,563	$ –	$ 25,969
Purchases of receivables portfolios	39,030	–	–	39,030
Transfers of portfolios	1,271	(1,271)	–	–
Gross collections	(41,193)	(2,962)	(5,274)	(49,429)
Adjustments	(1,150)	–	–	(1,150)
Revenue recognized	27,307	–	5,274	32,581
Balance, end of period	$ 45,671	$ 1,330	$ –	$ 47,001
Revenue as a percentage of collections	66.3%	0.0%	100.0%	65.9%

Total revenue recognized related to portfolios worked is comprised of two components – those portfolios that have a book basis and which are on accrual basis and those that have collected more than forecasted and have fully recovered their book value. The table below recaps the revenue recognized from each of these sources for the following periods (*in thousands*):

For the Years Ended December 31,

Revenue component	2002	2001	$ Change	% Change
Accrual basis portfolios	$ 76,043	$ 27,307	$ 48,736	178.5%
Weighted average effective interest rate	160.9%	87.3%		
Zero Basis Portfolios	$ 4,918	$ 5,274	(356)	(6.8)
Total owned portfolio revenue	$ 80,961	$ 32,581	48,380	148.5
Total owned portfolio revenue as a percentage of our average aggregate investment in receivable portfolios	171.3%	105.1%		

The annualized weighted average effective interest rate for receivables portfolios on the accretion method was 160.9% for the twelve months ended December 31, 2002, compared to 87.3% for the twelve months ended December 31, 2001. The increase in the effective interest rate is primarily due to the increasing proportion of our investment in receivables portfolios purchased since mid-2000 that have a higher effective rate than those portfolios purchased prior to mid-2000. The annualized effective interest rate is the accrual rate utilized in recognizing revenue on our accrual basis portfolios. This rate represents the monthly internal rate of return, which has been annualized utilizing the simple interest method. The monthly internal rate of return is determined based on the timing and amounts of actual cash received and the anticipated future cash flow projections for each pool.

The following table summarizes the changes in the balance of the retained interest and the proportion of revenue recognized as a percentage of collections during the following periods (*in thousands*):

	For the Years Ended December 31,	
	2002	2001
Balance, beginning of period	$ 17,926	$ 31,616
Gross collections	(13,929)	(20,675)
Amortization of unrealized gain	(1,448)	(2,871)
Adjustments	—	50
Revenue recognized	5,707	9,806
Balance, end of period	$ 8,256	$ 17,926
Revenue as a percentage of collections	41.0 %	47.4 %

The annualized effective interest rate for the retained interest was 47.2% for the twelve months ended December 31, 2002, compared to 39.8% for the twelve months ended December 31, 2001.

Operating Expenses

Total operating expenses were $63.9 million for the year ended December 31, 2002 compared to $46.8 million for the year ended December 31, 2001, an increase of $17.1 million or 36.5%. This increase is primarily volume-related, driven by a 79.2% increase in gross collections. The gross collections for the year ended December 31, 2002 amounted to $148.8 million, up 79.2% or $65.8 million from the $83.0 million of gross collections for the year ended December 31, 2001.

The largest component of total operating expenses is salaries (including bonuses) and employee benefits which increased by $7.7 million or 28.1% to $35.1 million for the year ended December 31, 2002 from $27.4 million for the year ended December 31, 2001. The 28.1% increase in salaries and benefits is the result of an increase in the average number of our employees. The average number of employees of 573 for the year ended December 31, 2002 grew by 35 or 6.5% from the 538 employees for the year ended December 31, 2001. Total salaries and benefits as a percentage of collections for the years ended December 31, 2002 and 2001 were 23.6% and 33.0%, respectively. Also included in salaries in the second quarter of 2002 is a $0.5 million settlement paid to a former executive officer.

We believe our success is directly related to our ability to attract and retain skilled employees. The retention rate of experienced collectors employed at the beginning of the year and who remained employed through the end of the period were 81.0% and 70.0% for the years ended December 31, 2002 and 2001, respectively. The retention rates of inexperienced collectors (defined as those collectors in our training program at the beginning of the year, plus all new hires during the period who remained employed through the end of the year) were 63.8% and 51.0% for the years ended December 31, 2002 and 2001, respectively.

Other operating expenses increased approximately $2.2 million, or 38.6%, to $7.9 million for the year ended December 31, 2002 from $5.7 million for the twelve months ended December 31, 2001. The increase was primarily a result of a $1.3 million increase in direct mail campaign costs and a $0.4 million increase in skip tracing expense during the year ended December 31, 2002.

Gross collections through the legal channel amounted to $27.6 million for the year ended December 31, 2002, representing growth of 69.2% above the $16.3 million collected during the prior year. The cost of legal collections reflects those costs associated with the business channel dedicated to collecting on accounts that have been determined to be collectible, but which require tactics other than telephone solicitation. The corresponding costs of legal collections amounted to $11.0 million or 39.9% of gross collections through this channel for the year ended December 31, 2002 as compared to the $5.5 million or 33.4% for the year ended December 31, 2001. The increase in the legal costs reflects an increased provision for uncollectible court costs of $1.6 million for the year ended December 31, 2002 as compared to $0.5 million for the prior year. The higher provision is based on our analysis of court costs that we have advanced, recovered, and anticipate recovering. The reserve of $2.1 million on court costs advanced of $3.3 million represents those costs that we believe will be ultimately uncollectible as of December 31, 2002.

General and administrative expenses increased to $6.3 million for the twelve months ended December 31, 2002, from $5.7 million for the twelve months ended December 31, 2001. The increase was primarily a result of an increase in insurance costs, which increased $0.6 million from $0.6 million for the year ended December 31, 2001, to $1.2 million for the year ended December 31, 2002. We have been able to leverage our collections, increasing gross collections 79.2% to $148.8 million from $83.0 million during the year ended December 31, 2002 compared to the year ended December 31, 2001, while maintaining a 10.5% increase in general and administrative expenses.

Depreciation expense remained consistent at $2.5 million for the twelve months ended December 31, 2002 and 2001.

We recorded a provision for portfolio losses of $1.0 million in the year ended December 31, 2002 related to the impairment of certain receivables portfolios.

Interest Expense

The following table summarizes our interest expense (*in thousands*):

	For the Years Ended December 31,			
	2002	2001	$ Change	% Change
Stated interest on debt obligations	$ 3,859	$ 5,784	$ (1,925)	(33.3)%
Amortization of loan fees and other loan costs	1,685	2,783	(1,098)	(39.5)
Contingent interest	13,048	2,378	10,670	448.7

Total interest expense	$ 18,592	$ 10,945	$ 7,647	69.9

For the year ended December 31, 2002, total interest expense including fees and amortization of other loan costs was $18.6 million on average borrowings for the period of $55.8 million, reflecting an effective interest rate of 33.3% for the period. The interest only portion of this total amounted to $3.9 million. The remaining portion of interest expense consists primarily of amortization of loan fees and other loan costs, and contingent interest expense related to the sharing of residual collections with our Secured Financing Facility lender. For the year ended December 31, 2001, total interest expense including fees and amortization of other loan costs was $10.9 million on average borrowings for the period of $64.2 million, reflecting an effective interest rate of 17.0% for the period. The interest only portion of this total amounted to $5.8 million. The remaining portion of interest expense consists primarily of amortization of loan fees and other loan costs, and contingent interest expense related to the sharing of residual collections with our Secured Financing Facility lender.

As discussed in Note 8 to the consolidated financial statements, we expensed $13.0 million and $2.4 million related to the sharing of residual collections with our Secured Financing Facility lender for the years ended December 31, 2002 and 2001, respectively, resulting in an increase in contingent interest expense of $10.6 million.

Income Taxes For the year ended December 31, 2002, we recorded an income tax benefit of $5.7 million, which is an effective benefit of 70.5% of pretax income. The provision for 2002 reflects the recognition of an income tax benefit in 2002 resulting from the restoration of a million net deferred tax asset (see Note 9 to the consolidated financial statements). For the year ended December 31, 2001, we recorded an income tax provision of $1.1 million, reflecting an effective rate of 11.8%, which represents the deferred tax impact of the decrease in the unrealized gain on the retained interest. The provision for that period excluded taxes on pre-tax income as a result of a change in the valuation reserve on our deferred tax assets, which existed at that time. For the year ended December 31, 2002, we determined that the utilization of net operating losses and other deferred tax assets was more likely than not, and therefore removed all but $0.2 million of the valuation allowance. The change in the valuation allowance resulted in the recognition of a current tax benefit in the amount of $9.9 million in the fourth quarter of 2002. This current tax benefit combined with a deferred tax expense, resulted in a net deferred tax benefit of $6.2 million. The utilization of our California net operating losses had been suspended by the state of California until 2004.

Net Income (loss) Net income for the twelve months ended December 31, 2002 was $13.8 million compared to a net loss of $10.9 million for the twelve months ended December 31, 2001.

Supplemental Financial Information
The following table is a reconciliation of GAAP net income and fully diluted earnings per share to net income and fully diluted earnings per share, excluding one-time benefits for the years presented. We believe that these non-GAAP financial measures provide useful information to investors about our results of operations because the elimination of one-time benefits that are included in the

GAAP financial measures results in a normalized comparison between the periods presented. (*in thousands, except per share amounts*):

	Years Ended December 31,	
	2002	2001
Net Income		
GAAP, as reported	$ 13,789	$ (10,865)
Benefit from restoration of net deferred tax assets [1]	(9,887)	–
Net income, excluding one-time benefits	$ 3,902	$ (10,865)
Percentage increase over prior period	135.9%	
Fully Diluted Earnings Per Share		
GAAP, as reported	$ 0.84	$ (1.52)
Benefit from restoration of net deferred tax assets [1]	(0.60)	–
Fully diluted earnings per share, excluding one-time benefits	$ 0.24	$ (1.52)
Percentage increase over prior period	115.8%	

1 This is the result of a change in the valuation allowance associated with our net tax assets as of December 31, 2002, which resulted in the recognition of a current tax benefit in the amount of $9.9 million, or $0.60 per fully diluted share during the year ended December 31, 2002 (see Note 9 to the consolidated financial statements).

Liquidity and Capital Resources

The following table summarizes cash and cash equivalents, notes payable, and stockholders' equity (deficit) for the years presented (*in thousands*):

	2003	2002	2001
Cash and cash equivalents	$ 38,612	$ 752	$ 1,412
Notes payable	41,178	47,689	69,215
Stockholders' equity (deficit)	71,371	19,542	(2,358)

Liquidity

We normally meet our operating requirements by:

- using cash flows from operating activities;
- utilizing our $75 million Secured Financing Facility; and
- utilizing other financing for the acquisition of specific assets such as capital leases

For the year ended December 31, 2003, we realized net income of $18.4 million, which included the after tax effect of $4.4 million resulting from a litigation settlement (see Note 4 to the consolidated financial statements). For the twelve months ended December 31, 2002, we realized net income of $13.8 million, which included the restoration of a $6.8 million net deferred tax asset (see Note 9 to the consolidated financial statements).

On October 1, 2003, the Company and certain selling stockholders completed a follow-on public offering of 5.0 million shares of common stock at $11.00 per share. The proceeds we received from the 3.0 million shares we offered, net of the underwriters' commissions and offering expenses of $2.9 million, totaled approximately $30.1 million. In addition, we received approximately $0.5 million in payment of the exercise price of options and warrants relating to shares offered by certain stockholders. We did not receive any of the proceeds from the 2.0 million shares offered by selling stockholders.

On October 21, 2003, the underwriters of the public offering completed the exercise in full and closed the sale of their over-allotment option to purchase an additional 750,000 shares of our common stock from selling stockholders at $11.00 per share, less the applicable underwriting discount. We received approximately $29,000 from the exercise of options relating to certain shares included in the over-allotment option. We did not receive any proceeds from the sale of the 750,000 additional shares by selling stockholders.

As a result of our follow-on public offering and our net income for the year, our stockholders' equity increased to $71.4 million as of December 31, 2003. Our stockholders' equity was $19.5 million as of December 31, 2002, which included the forgiveness of certain debt and the issuance of preferred stock occurring during the first quarter of 2002. This was a $21.9 million increase from the stockholders' deficit of $2.4 million at December 31, 2001.

We are in compliance with all covenants under our financing arrangements. We have achieved positive cash flows from operations of $34.0 million during the year ended December 31, 2003, which was a $9.3 million increase from the $24.7 million in cash flows from operations for the year ended December 31, 2002. We had positive cash flows from operations of $8.9 million during the year ended December 31, 2001, which was an increase from the $15.8 million in cash flows used in operations during the year ended December 31, 2000. We have achieved eight consecutive quarters of positive net income.

We believe that there is sufficient liquidity, given our expectation of continued positive cash flows from operations, our cash and cash equivalents of $38.6 million as of December 31, 2003, $35.0 million in availability as of December 31, 2003 under our Secured Financing Facility (see Note 8 to the consolidated financial statements), the repayment of a securitized receivable acquisition facility entered into by 99-1 ("Securitization 99-1") and a securitized receivable acquisition facility entered into by 98-A (the "Warehouse Facility") (see Notes 6 and 8 to the consolidated financial statements), our recent $1.8 million secured financing arrangement ("Secured Financing") (see Note 8 to the consolidated financial statements), and the repayment in full of our Senior Note that occurred on October 1, 2003 (see Note 8 to the consolidated financial statements) to fund operations for at least the next 12 months.

Capital Resources

Cash and Cash Equivalents Unrestricted cash and cash equivalents as of December 31, 2003 was $38.6 million compared to $0.8 million at December 31, 2002. The follow-on public offering and the increase in cash generated from operations have permitted us to avoid borrowing for purposes other than portfolio acquisition.

Secured Financing Facility On December 20, 2000, through a wholly owned bankruptcy-remote, special-purpose entity, we entered into the $75.0 million Secured Financing Facility, which expires on December 31, 2004. The Secured Financing Facility generally provides for a 90% advance rate with respect to each qualified receivable portfolio purchased. Interest accrues at the prime rate plus 3.0% per annum and is payable weekly. The applicable interest rate is 1.0% lower on outstanding amounts in excess of $25.0 million. Notes to be issued under the facility are collateralized by the charged-off receivables that are purchased with the proceeds from this financing arrangement. Each note has a maturity date not to exceed 27 months after the borrowing date. Once the notes are repaid and we have been repaid our investment, we share with the lender the residual collections from the receivable portfolios, net of our servicing fees. The sharing in residual cash flows continues for the entire economic life of the receivable portfolios financed using this facility, and will extend substantially beyond the expiration date of the Secured Financing Facility. New advances for portfolio purchases under the Secured Financing Facility would not be available beyond the December 31, 2004 expiration date. We are required to give the lender the opportunity to fund all of our purchases of charged-off credit card receivables with advances on the Secured Financing Facility through December 31, 2004 (see Note 8 to the consolidated financial statements).

The assets pledged under this financing facility, together with their associated cash flows, would not be available to satisfy claims of general creditors against us. In conjunction with the Secured Financing Facility, we issued warrants to purchase up to 621,576 shares of Encore's common stock at $1.00 per share, all of which were exercised in December 2003.

From the inception of the Secured Financing Facility through December 31, 2003, we purchased portfolios utilizing this facility at an aggregate purchase price of $183.3 million ($164.3 million of which was financed through this facility). As of December 31, 2003, there was $39.9 million outstanding under the facility (see Note 8 to the consolidated financial statements). During the year ended December 31, 2003, we repaid $59.9 million in principal, $2.2 million in interest, and $14.5 million in contingent interest pursuant to the residual collections sharing arrangement under the Secured Financing Facility. The Secured Financing Facility is collateralized by certain charged-off receivable portfolios with an aggregate carrying amount of $82.8 million at December 31, 2003. The assets pledged under this financing facility, together with their associated cash flows, would not be available to satisfy claims of our general creditors.

For the year ended December 31, 2003, we expensed $2.3 million in interest and loan fee amortization, and $16.0 million in contingent interest expense for total Secured Financing Facility related interest expense of $18.3 million, which represented an effective interest rate of 58.3% on average borrowings of $31.4 million. For the year ended December 31, 2002, we expensed $1.8 million in interest and loan fee amortization, and $13.1 million in contingent interest expense for total Secured Financing Facility related interest expense of $14.9 million, which represented an effective interest rate of 66.2% on average borrowings of $22.4 million.

We intend to replace or renegotiate this facility by the end of its term.

The following table summarizes our repayment of debt related to our receivable purchases under the Secured Financing Facility for the following periods as of December 31, 2003 (*in millions*):

Period	Secured Financing Facility Original Borrowings	Remaining Balance as of December 31, 2003	Percent of Original Borrowings Remaining
2001	$ 35.0	$ 0.0	0.0%
Q1 2002	11.7	Less than 0.1	0.0
Q2 2002	9.4	0.1	0.6
Q3 2002	18.1	0.3	1.6
Q4 2002	15.1	2.8	18.7
Q1 2003	17.0	3.8	22.7
Q2 2003	22.0	8.5	38.8
Q3 2003	15.8	8.2	51.9

Q4 2003	20.2	16.2	80.3
Total	$ 164.3	$ 39.9	24.3

Secured Financing On July 25, 2003, through a wholly owned, bankruptcy-remote, special-purpose entity, we entered into a $1.8 million secured financing arrangement to finance the purchase of non-credit card debt (the "Secured Financing"). The Secured Financing provided for a 75.0% advance rate with respect to four purchased receivable portfolios of charged-off unsecured consumer loans and auto loan deficiencies. Interest accrues at 15.0% and is payable weekly. This note has a maturity date not to exceed October 25, 2005. The Secured Financing is collateralized by charged-off receivables from four receivable portfolios with an aggregate carrying value of $1.9 million as of December 31, 2003. Unlike the Secured Financing Facility, this financing arrangement does not require us to share residual collections with the lender. The assets pledged under this financing, together with their associated cash flows, would not be available to satisfy claims of general creditors of the Company.

Revolving Line of Credit We entered into the Seventh Amended and Restated Promissory Note effective April 10, 2003, to renew our revolving line of credit. Availability under the revolving line of credit, which carried interest at the Prime Rate and matured on April 15, 2004, was reduced from $15.0 million to $5.0 million. Certain stockholders of Encore guaranteed this unsecured revolving line of credit. In connection with the guaranties, we have paid an aggregate fee of $75,000 per quarter to certain of the guarantors/stockholders. There were no amounts outstanding under the revolving line of credit at the time of termination. On October 14, 2003, we terminated this revolving line of credit, and the guarantors were released from their obligation and no further payments will be made to the guarantors.

Securitizations In 1998, we engaged in a securitization transaction that was treated as a sale and not as a secured financing transaction. We recorded a retained interest in securitized receivables. The retained interest is collateralized by the credit card receivables that were securitized, adjusted for amounts owed to the note holders. The gross collections related to the retained interest amounted to $6.8 million for the year ended December 31, 2003; $13.9 million for the year ended December 31, 2002; and $20.7 million for the year ended December 31, 2001. The related income accrued on the retained interest amounted to $0.3 million for the year ended December 31, 2003; $5.7 million for the year ended December 31, 2002; and $9.8 million for the year ended December 31, 2001. Since repaying the note in September 2000, we have retained all collections of the underlying securitized receivables.

On March 31, 1999, through a bankruptcy remote, special purpose subsidiary, we entered into a $35 million securitized receivables acquisition facility (the "Warehouse Facility") that was structured as a term loan with a final payment date of December 15, 2004. The Warehouse Facility, including the deferred insurance premium, was repaid in full on April 15, 2003. As of December 31, 2002, the balance outstanding under this facility was $5.6 million (see Note 8 to the consolidated financial statements). The facility accrued interest at 1.17% plus the one-week London interbank offered rate ("LIBOR") totaling 2.67% per annum at December 31, 2002.

On January 18, 2000, through a bankruptcy remote, special purpose subsidiary, we issued securitized non-recourse notes in the amount of $28.9 million, bearing interest at 10% per annum ("Securitization 99-1"). The Securitization 99-1, including the deferred insurance premium, was repaid in full on April 15, 2003. The outstanding balance under this facility was $6.6 million at December 31, 2002 (see Note 8 to the consolidated financial statements).

The Warehouse Facility and Securitization 99-1 were insured through a financial guaranty insurance policy. The insurance policy required the payment of a base premium on a monthly basis and an additional premium, which was due at the debt maturity. The deferred premium totaled $1.3 million and $1.9 million at December 31, 2001 and 2002, respectively, which was reflected in accounts payable and accrued liabilities.

Senior Notes In January 2000, we obtained financing through the issuance of $10.0 million principal amount senior notes to an institutional investor. On October 1, 2003, the remaining balance of the Senior Notes was repaid in full. The notes were our unsecured obligations, but were guaranteed by Midland Credit Management and one of our stockholders. In connection with the issuance of the notes, we issued warrants to the note holders and the guaranteeing stockholder to acquire up to an aggregate of

528,571 shares of our common stock at an exercise price of $0.01 per share.

On February 22, 2002, the institutional investor forgave $5.3 million of outstanding debt, consisting of a $2.8 million reduction in the original note balance, the forgiveness of $1.9 million in Payment-in-Kind Notes, and the forgiveness of $0.6 million in interest accrued through December 31, 2001, and reduced its warrant position by 200,000 warrants (see Note 3 to the consolidated financial statements). In conjunction with the debt forgiveness, capitalized loan costs totaling $0.1 million and debt discount totaling $0.5 million were written-off. The net gain on debt forgiveness totaling $4.7 million was reflected as an adjustment to stockholders' equity. Furthermore, the terms of the Senior Notes and Payment-in-Kind Notes were revised. The interest rate on the remaining $7.3 million in Senior Notes was 6.0% per annum until July 15, 2003 and 8.0% per annum from July 16, 2003 to October 1, 2003, when the Senior Notes were repaid in full. In addition, warrants totaling 233,812 held by the institutional investor and 101,275 held by the guaranteeing stockholder were exercised concurrent with the our follow-on public offering. The remaining debt discount and capitalized loan fees associated with the Senior Note in the amount of $0.9 million were written off and charged to income in the fourth quarter of 2003.

Preferred Stock In a transaction related to the forgiveness of debt discussed above, certain existing stockholders and their affiliates (the "Purchasers") made an additional $5.0 million investment in Encore to purchase 1,000,000 shares of Series A Senior Cumulative Participating Convertible Preferred Stock. Immediately prior to such investment, the Purchasers beneficially owned in excess of 50% of our common stock on a collective basis. This debt forgiveness and sale of preferred stock increased our net worth by $9.3 million. The preferred stock was entitled to dividends and other significant rights and privileges.

On October 1, 2003, concurrent with our public offering, all the holders of the Series A Preferred Stock converted their shares into 10.0 million shares of common stock pursuant to an agreement executed between the holders of such shares and the Company. The holders of the Series A Preferred Stock were paid all accrued and unpaid dividends totaling $63,889 at the time of the conversion in accordance with the terms of the Series A Preferred Stock, but did not pay or receive any other consideration in connection with the conversion (see Note 3 to the consolidated financial statements).

Future Contractual Cash Obligations

The following table summarizes our future contractual cash obligations as of December 31, 2003 (*in thousands*):

	2004	2005	2006	2007	2008	Total
Capital lease obligations	$ 199	$ 193	$ 68	$ –	$ –	$ 460
Operating leases	800	390	390	390	292	2,262
Employment agreements	604	184	–	–	–	788
Secured Note	80	86	53	–	–	219
Debt - variable principal payments (Secured Financing)	1,031	–	–	–	–	1,031
Debt - variable principal payments (Secured Financing Facility)	27,076	12,684	168	–	–	39,928
Total contractual cash obligations	$ 29,790	$ 13,537	$ 679	$ 390	$ 292	$ 44,688

Repayments under our Secured Financing Facility and Secured Financing are predicated on our cash collections from the underlying secured receivables portfolios; however, repayment must be made no later than 27 months following the date of the original advance with respect to each advance under the Secured Financing Facility, and October 25, 2005 under our Secured Financing. The table reflects the repayment of the loans under these facilities based upon our expected cash collections, which reflects repayments earlier than the required due dates.